DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 02-0098
ADJUSTED GROSS INCOME TAX
For the Tax Year 1997

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ISSUES

I. Allocation of Taxpayer's Income Received from Indiana Partnership Interests – Adjusted Gross Income Tax.

Authority: IC 6-3-2-2; Hunt Corp. v. Indiana Dept. of State Revenue, 709 N.E.2d 766 (Ind. Tax Ct. 1999); 45 IAC 3.1-1-153; 45 IAC 3.1-1-153(b); 45 IAC 3.1-1-153(c); 45 IAC 3.1-1-153(c)(2); 45 IAC 3.1-1-153(e).

Taxpayer argues that income received from the disposition of Indiana partnership interests should be allocated to California and that the audit erred in determining the income should be allocated to Indiana.

II. Partnership Net Operating Losses.

Authority: IC 6-3-2-2; Hunt Corp. v. Indiana Dept. of State Revenue, 709 N.E.2d 766 (Ind. Tax Ct. 1999)

Taxpayer argues that it is entitled to carry forward net operating losses from the tax years 1992 through 1997.

III. Abatement of the Ten-Percent Negligence Penalty.

Authority. IC 6-8.1-10-2.1; IC 6-8.1-10-2.1(d); 45 IAC 15-11-2(b); 45 IAC 15-11-2(c).

Taxpayer maintains that it had a reasonable basis for the decisions it reached with respect to its Indiana tax liabilities. As a result, the taxpayer argues that the Department should exercise its discretion to abate the ten-percent negligence penalty.

STATEMENT OF FACTS

Taxpayer is a California corporation which owned an interest in two partnerships. The two partnerships directly or indirectly owned an Indiana hotel. First Partnership directly owned the hotel. Second Partnership's sole business purpose was to own an interest in First partnership.

During 1997, First Partnership sold the Indiana hotel property. Subsequently both First Partnership and Second Partnership were liquidated, and taxpayer received "distributive shares" of the partnerships' income.

Prior to 1997, First and Second Partnerships' income was 100 percent allocated to Indiana. After the hotel was sold, the Department of Revenue (Department) issued notices of "Proposed Assessment" based upon the income taxpayer derived from the partnership liquidations. Subsequently, taxpayer filed amended federal and state returns to report changes in the allocation of the distributive shares. In reporting that income, taxpayer carried forward a substantial net operating loss (NOL) from 1992 through 1995 with the result that taxpayer claimed it owed "no adjusted gross income tax and supplemental net income" for 1997.

The Department conducted a review of taxpayer's amended return and disagreed with taxpayer's position. The taxpayer challenged the Department's decision, an administrative hearing was held, and this Letter of Findings results.

FINDINGS

I. Allocation of Taxpayer's Income Received from Indiana Partnership Interests – Adjusted Gross Income Tax.

Taxpayer maintains that the money it received from the liquidation of the two partnerships should be allocated outside Indiana. The Department determined that because the partnerships' income was derived from the sale of Indiana property, the income should be allocated to Indiana.

The Indiana Tax Court has stated that a corporate partner's income is determined by apportionment at the corporate partner's level when the corporate partner and the partnership have a unitary relationship. Hunt Corp. v. Indiana Dept. of State Revenue, 709 N.E.2d 766, 778 (Ind. Tax Ct. 1999). The court made its decision based on the application of IC 6-3-2-2 and appeared to find that 45 IAC 3.1-1-153 was a reasonable application of the apportionment statute. Id. at 777. In applying IC 6-3-2-2 to corporate partnerships, the court stated:

> If the income from the partnerships constitutes business income (i.e. if the affiliated group and the partnerships are engaged in a unitary business) under section 6-3-2-2, all of that income would be subject to apportionment based on an application of the affiliated group's property, payroll, and sales factors. If the income from the partnerships constitutes non-business income for the affiliated group *(i.e. if the affiliated group and the partnerships are not engaged in a unitary business), that income would be allocated to a particular jurisdiction*. Id at 776. (*Emphasis added*).

The court plainly states that all of a corporate partner's income from a partnership with a unitary relationship to that partner is business income and further states that all of a corporate partner's income from a partnership with a non-unitary relationship is non-business income. This means that there is no business / non-business distinction at the partnership level regardless of the relationship between the partner and the partnerships.

45 IAC 3.1-1-153 governs the manner in which taxpayer's partnership income is treated for adjusted gross income tax purposes. 45 IAC 3.1-1-153(c) states that, "If the corporate partner's activities and the partnership's activities do not constitute a unitary business under established standards, disregarding ownership requirements, the corporate partner's share of the partnership income attributable to Indiana shall be determined as follows."

It is not disputed that taxpayer and the two partnerships did not share a unitary relationship. It is not disputed that the two partnerships' income was derived from the sale of the Indiana hotel property. It is not disputed that taxpayer received its share of this income – at the time the partnerships were liquidated – in the form of "distributive shares" in the former partnerships. Accordingly, the distributive share income is governed under 45 IAC 3.1-1-153(c)(2) which states that, "If the partnership derives business income from sources entirely within Indiana, or entirely without Indiana, such income shall not be subject to formula apportionment." In regards to taxpayer's distributive share income, the rule states, "After determining the amount of business income attributable to Indiana . . . the corporate partner's distributive share of such income shall be added to the corporate partner's other business income apportioned to Indiana and its nonbusiness income, if any, allocable to Indiana, in determining the corporate partner's total taxable income." 45 IAC 3.1-1-153(e).

Taxpayer received partnership distributions of income derived from the sale of the Indiana hotel property. This income was "entirely derived from sources within Indiana." 45 IAC 3.1-1-153(c)(2). Therefore, the total amount of the partnership distributions is added to taxpayer's "other business income apportioned to Indiana and its nonbusiness income, if any, allocable to Indiana." 45 IAC 3.1-1-153(e). The audit review correctly determined that taxpayer's distributive share income derived from the two partnerships should be used "in determining the corporate partner's total taxable income." 45 IAC 3.1-1-153(e). Under Indiana law, there is no basis for taxpayer's assertion that the state should allocate this income elsewhere.

FINDING

Taxpayer's protest is respectfully denied.

II. Partnership Net Operating Losses.

Taxpayer argues that it is entitled to carry forward NOLs from 1992 through 1995. As a result of that carry-forward, taxpayer concludes that it has no tax liability for 1997.

The 1992 through 1995 losses were attributable to partnerships with which taxpayer – by its own admission – did not have a unitary relationship. As stated by taxpayer, "[Taxpayer] had no connections to Indiana other than [the] partnerships. [Taxpayer] did not share any centralized management, executive force, centralized purchasing, advertising, accounting, or other controlled interaction with [partnerships]."

In order for the taxpayer to bring the 1992 through 1995 partnership losses within the apportionment provisions of IC 6-3-3-2, the taxpayer must first demonstrate that the income (or

losses) are attributable to a partnership with which it has a unitary relationship. Hunt Corp. v. Indiana Dept. of State Revenue, 709 N.E.2d 766, 776 (Ind. Tax Ct. 1999). "[I]f the affiliated group and partnerships are not engaged in a unitary business that income will be allocated to a particular jurisdiction." Id. Because the losses were incurred by partnerships with which it did not have a unitary relationship, the losses are irrelevant in determining the taxpayer's own adjusted gross income tax liability.

FINDING

Taxpayer's protest is respectfully denied.

III. Abatement of the Ten-Percent Negligence Penalty.

Taxpayer asks the Department to exercise its discretion and abate the ten-percent negligence penalty.

IC 6-8.1-10-2.1 requires that a ten-percent penalty be imposed if the tax deficiency results from the taxpayer's negligence. Departmental regulation 45 IAC 15-11-2(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." Id.

IC 6-8.1-10-2.1(d) allows the Department to waive the penalty upon a showing that the failure to pay the deficiency was based on "reasonable cause and not due to willful neglect." Departmental regulation 45 IAC 15-11-2(c) requires that in order to establish "reasonable cause," the taxpayer must demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed . . . ."

Taxpayer asserts that it prepared its amended returns based upon a good faith interpretation of Indiana statutes, that it was not negligent, and that it did not intentionally disregard the law. In sum, taxpayer maintains that it had a reasonable basis for the decisions it made in regard to its Indiana tax liability.

The Department agrees with taxpayer that the positions it took in regard to its Indiana tax liabilities – however erroneous – were indicative of "reasonable cause and not due to willful neglect."

FINDING

Taxpayer's protest is sustained.

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